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Business Continuation Planning

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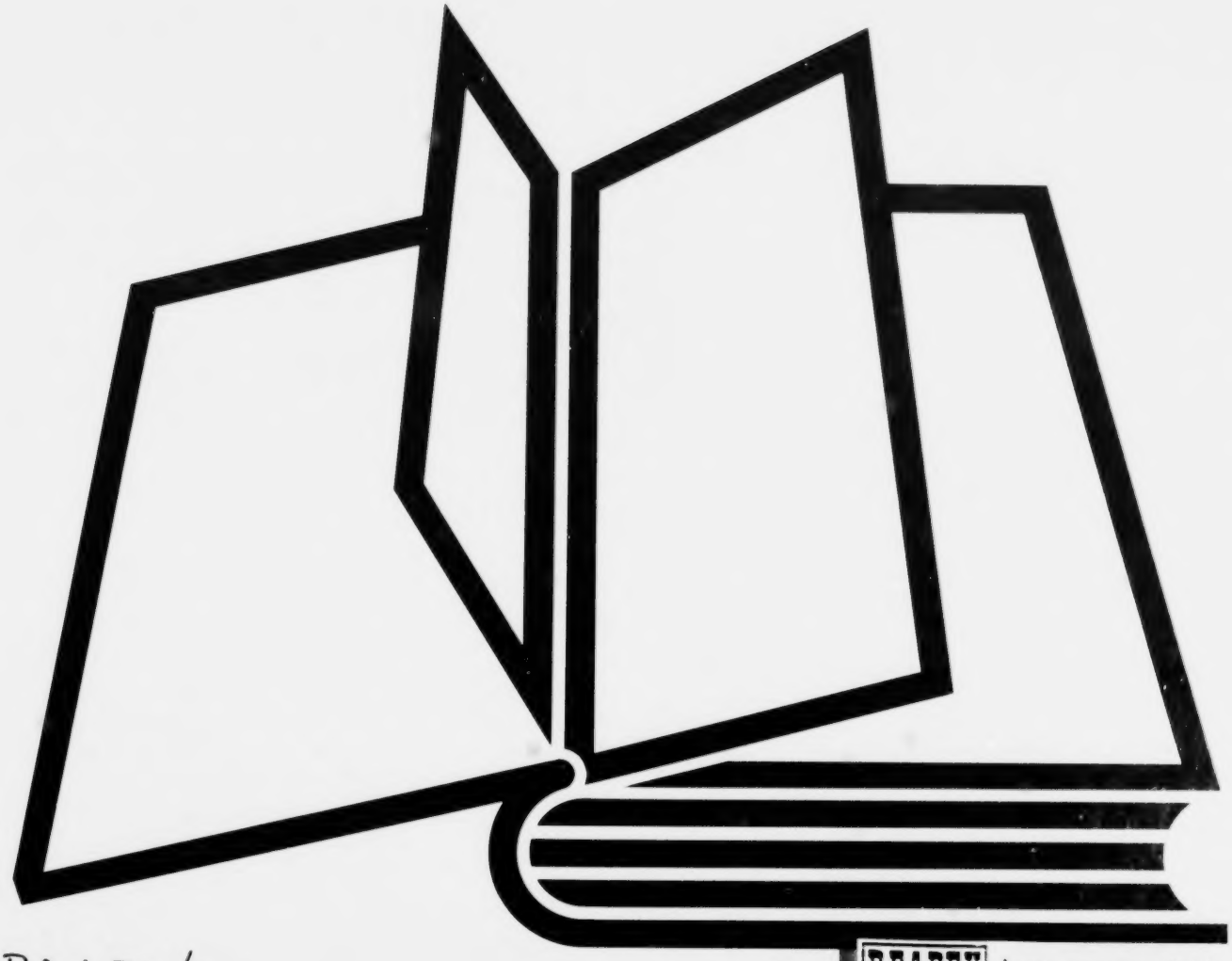

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SUMMARY

This publication provides an overview of business owners' life insurance needs that typically are not considered until after the death of one of the business' principal owners or shareholders. It has specific alternatives for your consideration when planning for the future of your business. It outlines how business life insurance applies to various business situations. Additionally, this publication demonstrates the benefits of the insurance for the surviving heirs and the estate of a deceased owner, as well as its being a means of paying retirement income and insurance premium during the owner's life.

Life insurance can provide significant amounts of cash to help employees and family members cushion the financial impact of the death or retirement of the owner-manager of a sole proprietorship, partnership or a closely-held corporation. It can also help attract and retain valuable employees.

This brochure discusses life insurance needs of small business owners and how business life insurance applies to their situations.

The small business owner usually depends on the business as the source of family income, a personal investment vehicle and the major portion of his/her estate. Generally, many of the assets of the sole proprietor, partner or close corporation stockholder are tied up in the business. So, if it fails, financial hardships may well follow unless certain steps are taken.

The personal insurance needs of the business owner are closely related to his/her business interest. The business can provide a portion of the cash needed by surviving heirs and the estate of a deceased owner, as well as a means of paying retirement income and insurance premiums during the owner's lifetime.

Problems at Death of a Sole Proprietor

The personal skills, reputation, and management ability of the sole proprietor help to make the business successful. Without these human life values the business is worth only the liquidation value of the tangible assets.

The sole proprietor's personal and business assets are one and the same. When death occurs, the loss can become a financial disaster to the proprietor's estate and fatal to the business. The business which was producing a good living for the owner and family would become a defunct business. Once representing the major portion of the sole proprietor's estate, the family is left with only the auction price value of the business.

Possible Actions

Family continuation of the business

The business may be transferred to a capable family member as a gift through provisions in the proprietor's will or by a sale provided through a prearranged purchase agreement effective at death.

Cash is needed to offset losses to the business caused by the owner's death, to equalize the value of bequests made to other family members if the transfer is a gift, and to provide the sale price if the transfer is through sale.

New owner

If the buyer is a key employee, competitor, or other person, the business may be transferred at death, pursuant to a prearranged sale agreement.

However, cash is needed to provide a "business continuation fund" to meet expenses and perhaps to offset losses until the business adjusts to the new management.

Liquidation

If future management is not available, then the business must be liquidated.

Cash is needed to offset the difference between the business' going-concern value and its auction-block liquidation value to provide a fund for income replacement to the family and to pay outstanding business debts.

The least expensive and only sure way to provide the cash at the instant it is needed is through life insurance on the sole proprietor's life.

Sole Proprietor's Life Insurance Plan

Family continuation of the business

Life insurance:

Insured: the sole proprietor.

Applicant and owner: usually the sole proprietor but sometimes a beneficiary who has funds to pay the premium.

Beneficiary: those for whom the insurance proceeds are intended: the new owner (for the insurance to provide the business "shock fund" and sale price), family members (for the insurance to provide the equalization fund).

Sole proprietor's will: If the family member is to receive the business as a gift, this should be provided for in the will. Distribution in the will to other heirs may also be provided, keeping in mind any other life insurance proceeds they may receive.

Family buy-out: A binding buy and sell agreement, funded with life insurance, entered into by the sole proprietor and purchasing heir.

New Owner

Life insurance:

Insured: the sole proprietor.

Applicant and owner: the buyer.

Beneficiary: the buyer.

Buy-out agreement: A binding buy and sell agreement, funded with life insurance, should be entered into by the sole proprietor and the purchaser. Because a sole proprietorship is not a separate legal entity, the business assets may be titled in the sole proprietor's name, or jointly with his/her spouse. The business property should therefore be specifically described in the agreement, and the document signed by the spouse, the sole proprietor, and the purchaser.

Sole proprietor's will: The executor of the estate should be bound to sell the business to the named buyer and, when payment is received, directed to cooperate with the purchaser to effectuate the transfer of the business assets.

Liquidation

Life insurance:

Insured: the sole proprietor.

Applicant and owner: usually the sole proprietor but sometimes the spouse or other heir who pays the premiums.

Beneficiary: those for whom the insurance proceeds are intended.

Sole proprietor's will: The executor of the estate should be authorized to liquidate the business.

Problems At Death of a Partner

Unless there is a written agreement to the contrary, the death of a partner automatically dissolves the firm.

In the absence of an agreement to the contrary, surviving partners have no right to buy the deceased's partnership interest.

- Surviving partners cannot assume the goodwill or take over the assets without consent of the deceased's estate.

- If the deceased was in debt to the partnership, the estate must settle the account in full and in cash.

The surviving partners act as liquidating trustees.

- They have exclusive possession of firm property but no right to carry on the business. If the business is continued, the surviving partners must share all profits with the deceased's estate and are liable for all losses.

- They must convert everything into cash at the best price obtainable.

- They must make an accounting to the deceased's estate and divide the proceeds with the estate.

- They must liquidate themselves out of their business and income.

Possible Actions

Liquidation, arranged after death

If the surviving partner and deceased's heirs do nothing, the business is liquidated, resulting in "auction price" value for the salable assets. It may receive nothing for goodwill. This is a disastrous solution for both the dead partner's family and the surviving partners. It means termination of jobs for the surviving partners and employees.

Reorganization, arranged after death

The surviving partners may attempt to reorganize the partnership by:

- Taking the heirs into the partnership. But if heirs are incapable of working, the survivors must do all the work and share the profits.

- Accepting a new partner picked by heirs. But that person may lack ability or be unacceptable to the survivor(s). Also, the heirs may not receive a "going concern" value for their interest.

- Selling the surviving partner(s') interest to the heirs. It may take time to agree on a price and the heirs may have difficulty raising the funds. Also, besides being unemployed, the surviving partner(s) may have to accept poorly secured installment payments.

- Buying out the heirs. For both parties, agreeing on a fair price after a partner's death and making certain funds are available to consummate the deal present difficulties.

Reorganization, arranged before death

Buy and sell agreements

Buy and sell agreements funded with life insurance should be entered into while all partners are alive.

Determine the funding medium by applying for the insurance before the buy and sell agreement is finalized; the availability and price of life insurance can be determined as well as whether some other method of funding will be necessary.

The partners should be able to make a fairly accurate estimate of the value of the partnership, so proper amounts of insurance can be requested. The amount of the insurance proceeds often serves as the minimum purchase price or the amount of the down payment, if less than the full purchase price.

Each partner may be the applicant, owner and beneficiary of insurance on the life of each of the other associates. Or the partnership, as an entity, may be the applicant, owner and beneficiary of insurance on the lives of each partner.

Before the buy and sell agreement is in final form, have an accountant help you determine the current value of each partner's interest and how its value is to be reestablished from time to time.

Enter into a binding buy and sell agreement

Have an attorney draft the agreement which typically will include:

- A commitment by each partner not to dispose of the interest during his/her lifetime without first offering it at the agreed sale price to an associate (or directly to the partnership).
- A commitment by each associate (or the partnership) to buy a deceased's interest, and to bind each partner's own estate to sell at death.
- A commitment as to the purchase price (or a means of determining the price) and method of making the payment(s).
- A commitment as to the method of funding the agreed purchase price.

Partners' Life Insurance Plan

Life insurance:

Insured: each partner.

Applicant and owner: the buyer(s) of the partnership interest (co-partners or the partnership itself).

Beneficiary: the buyer(s) of the partnership interest (co-partners or the partnership itself).

Problems at Death of a Stockholder

The death of a stockholder who has been active in the operation of a closely-held corporation allows the business entity to continue its *legal* structure, but not its *personal* structure. The interests of the heirs of the deceased inevitably come in conflict with the interests of the surviving associates.

Surviving stockholders want business growth through reinvestment of profits. They continue to receive income through tax-deductible salaries and employee fringe benefits. The deceased's family wants immediate withdrawal of profits to provide continuing income, through non-deductible dividends.

Possible Solutions

Retention of stock by the heirs

The deceased's family may retain the stock interest. If the heirs have a majority interest, they may choose to become personally involved in management in order to receive income. Or, they may choose to remain inactive, elect a new board of directors and force the company to pay dividends.

In either case, the surviving stockholders may lose a voice in management and possibly their jobs, while the deceased's family may become heirs to a business on the brink of failure.

If the heirs have a minority interest and are not employed by the surviving associates, their only means of receiving an income from the corporation will be through dividends. But, the surviving stockholders can not afford to have much, if anything, paid as "double-taxed" dividends. This will result in a dissatisfied group of minority stockholders, who may become an intolerable nuisance factor.

Sale of stock by the heirs, arranged after death

After the death of a stockholder, the deceased's family or estate may offer to sell the stock interest to the surviving stockholders. The price the family thinks is reasonable may be exorbitant to the other stockholders.

Even if they can agree on a price, the buyers may have neither available cash nor the ability borrow the needed funds. Thus, the deceased's heirs may have to accept installment payments.

An outside buyer may be interested only in a majority interest. Any purchase offer of a minority interest will likely be less than the proportionate full value of the business as a "going concern."

The heirs may end up with less than the fair price, and the surviving stockholders may have a new associate who may be neither a capable employee nor a compatible member of the management team.

Sale of stock by the heirs, arranged before death

While all interested parties are alive, they can enter into a binding buy and sell agreement funded with life insurance.

When a death occurs:

- The deceased's heirs immediately receive a fair price in cash for the deceased's interest in the corporation.
- The surviving stockholders immediately have the cash to pay the agreed price and become sole owners of the business.
- Both parties benefit equally under the plan.

Stockholder's buy and sell agreement

Determine the funding medium:

Life insurance is the least expensive and only sure means of immediately guaranteeing cash when needed at the time of death. It should be applied for on the life of each stockholder. The amount can be determined by agreement of the associates as to the value of the business.

Applications should be submitted immediately so the availability and price of life insurance can be known prior to the attorney's drafting of the purchase and sale agreement.

The applicant, owner and beneficiary of a policy on the life of a stockholder should be the purchaser of that stockholder's stock. When few stockholders are involved, each may agree to purchase a pro-rata portion of the stock owned by each of the other shareholders. Or they may prefer to have the corporation be the purchaser of a deceased's entire stock interest. (Caution—If the stockholders are members of the same primary family group, other than brothers and sisters, careful legal and tax counseling is necessary to avoid adverse tax consequences if the corporation is to be the purchaser.)

Establish the purchase price

An accountant and/or lawyer can assist the stockholders in establishing fair and equitable current values and a means of determining how these valuations should be adjusted in the future.

These values must be determined prior to completion of the buy and sell agreement. If they are not in line with the amounts of life insurance which have been purchased, changes may have to be made to the insurance.

Enter into a binding buy and sell agreement

A lawyer will advise the stockholders whether to choose a cross purchase or a stock redemption plan and will prepare the necessary agreements. Under a cross purchase plan, each stockholder agrees to purchase a portion of an associate's stock interest. Under a stock redemption plan, the corporation agrees to purchase each stockholder's interest.

The provisions of a typical agreement to purchase stock of a close corporation generally include:

- A commitment by each stockholder not to dispose of the stock interest during his/her lifetime without first offering it, at the agreed sale price, to an associate, or to the corporation itself.
- A commitment by each stockholder (or the corporation) to buy the shares of a deceased stockholder and to bind his/her own estate to sell at death.
- A commitment as to the purchase price (or a means of determining the price) and method of making the payment(s).
- A commitment as to the method of funding the agreed purchases.

Stockholder's Life Insurance Plan

Life insurance:

Insured: each stockholder.

Applicant and owner: the buyer(s) of the stock (the co-stockholder(s) or the corporation).

Beneficiary: the buyer(s) of the stock (the co-stockholder(s) or the corporation).

Key Employee Insurance

Fire losses to buildings, or equipment breakdowns, may never occur, are seldom total, and usually can be repaired or replaced. Death loss is always total, and only people can replace people.

How to Offset the Loss of a Key Employee

It is impossible to provide an exact replacement of a deceased key person. The most effective offset to the value of the lost services is CASH, immediately available to the business.

- To offset losses during the readjustment period and keep it running.
- To retain good credit standing.
- To assure customers and suppliers that the company will continue as usual.
- To retire loans, mortgages, bonds, etc.
- To attract and train a successor.
- To continue paying salaries.
- To carry out ongoing plans for expansion and new developments.

Life insurance is the most economical and effective means of providing cash because:

- during life, the cash values constitute an increasing liquid tax-sheltered reserve, available to help meet any financial need of the business.
- at death, the full cash proceeds are immediately available. These funds are received completely free of income tax, even though the proceeds normally exceed the premiums by a substantial amount.

Key Employee Life Insurance Plan

There is no set formula to establish the value of each key individual. However, the following are some general guidelines:

- The capitalized value of that portion of the company's profits attributable to such person.
- The costs of replacing the key employee.
- Two to five times the key person's annual salary.

The business (employer, if a Sole Proprietorship) is the applicant, owner and beneficiary of an insurance policy on the life of the key individual. No form of agreement is necessary between the business and key employee except the individual's consent to be insured, evidenced by signing the application. Thus, the business has complete flexibility to use the policy: the cash values during life, the proceeds after death.

Though the primary purpose for the insurance is to indemnify the business for its loss of the key worker's human life value at death, the policy may also:

- Provide funds for sudden emergencies or unexpected opportunities.
- Bolster the credit standing of the company.
- Serve as collateral for confidential policy loans at a guaranteed interest rate.
- Provide funds which the corporation could use for the insured's retirement or for the family if the key person dies.

Life insurance:

Insured: the key person.

Applicant and owner: the employer.

Beneficiary: the employer.

Deferred Supplemental Compensation

A non-qualified Deferred Compensation Plan is an agreement made by an employer, backed by the good faith and credit of the concern, to pay an employee amounts at a date specified in the future in lieu of current salary increases which would be subject to current income tax or supplemental to normal salary. Payments normally commence at the employee's retirement but also may be made if the employee becomes disabled or dies. In consideration of such promised payments, the employee usually agrees to continue employment until retirement, and during retirement to be available as a consultant to the firm and refrain from competitive activity.

Deferred Supplemental Compensation Plan

The employer and employee enter into a written contract prepared by an attorney.

The employer generally agrees:

- To employ the executive at an agreed-upon current salary rate.
- To pay the employee a specified additional deferred salary for a certain number of years or lifetime, commencing at a stated retirement date, or in the event of preretirement, death or disability.
- To continue payments to the employee's beneficiary for a certain number of years if death occurs after retirement, but before receipt of all stipulated payments.
- To pay a death benefit (specified single sum or installment payments) to the spouse, if the executive dies before retirement.
- To pay the executive a certain salary for an agreed-upon period of time in event of total disability prior to retirement (normally funded through a Disability Income policy).

The executive generally agrees:

- To remain in the employ of the business for an agreed-upon number of years.
- To provide the company with occasional consulting or advising services during retirement.
- To refrain from providing service to any competitor during retirement.

A life insurance policy assures the company of the funds it will need to pay the promised benefits. The life of the executive is insured for an amount at least sufficient to provide the business with its deductible after-tax cost of the death or retirement payments. The business is the applicant, owner and beneficiary of the *life* insurance policy.

A *disability* income policy for the appropriate amount is provided to the employee with premiums paid by the employer.

Income Tax Aspects of the Deferred Compensation Plan

Premium payments made by the business for the life insurance policy are *not* deductible; disability income insurance premiums *are* deductible.

The employee incurs no current income tax on the amount of compensation deferred nor on the employer's premium payments for the insurance policies.

The cash value of the life policy accrues tax free to the business.

Proceeds of the life policy are received tax free by the business at the death of the insured. Benefits under the *disability* income policy are tax-reportable by the employee when and as received.

Deferred Compensation benefits for normal retirement or death are deductible by the business as they are paid to the employee or the employee's beneficiaries. Retirement

and/or death benefits are taxable to the recipient only when and as received (usually at a lower rate than that of the employee prior to retirement or death). Disability benefits are paid directly to the employee by the insurance company, hence are not deductible by the employer. (Instead, the premium payments are deductible.)

Life Insurance:	**Disability Income Insurance:**
Insured: the employee	the employee
Applicant and owner: the employer	the employee
Beneficiary: the employer	the employee

Family Death Benefit

This is a plan under which an employer agrees to make one or more payments, at the death of a key employee (usually if death occurs during active employment), to the deceased's family (usually the surviving spouse and/or children). In effect, it is a supplemental compensation plan which offers no retirement or disability payments for the employee, but instead defers all payments until after the employee's death. It is often called a Death Benefit Only (DBO) plan.

Death Benefit Only Plan

One or more employees are selected to participate in the plan. The employer offers the plan to each selected person, individually.

Usually, a plan provides a continuation of a specified portion of the employee's salary for a specified number of years, in event of the employee's death prior to retirement. If desired, the death benefit can be made in installments or in one sum. Moreover, benefits may be payable whenever death occurs, during active employment or retirement.

The employee agrees to be the insured in a life insurance policy owned and paid for by the employer. The amount of insurance purchased is at least equal to the employer's after-tax deductible cost of the death benefit payments. In most plans, the life insurance equals or exceeds the employer's total before-tax payments to the employee's family, thus providing sufficient tax free funds to cover not only the tax deductible payments to the family but most or all of the premiums paid for the insurance, and to allow for benefit increases that are tied to salary increases.

Income Tax Aspects of the Plan

- premium payments made by the employer are not a deductible business expense.
- The insured employee incurs no income tax as a result of the plan.
- Policy cash value increases are accrued tax free to the employer-owner of the policy.
- The policy death proceeds are received free of income tax by the employer-beneficiary.

Payments made by the employer to the deceased's family are deductible as paid (so long as they are not unusually generous if paid to the families of substantial stockholder-employees).

The benefits are included as taxable income of the recipient as received. (Usually, the deceased's spouse is in a relatively low tax bracket and the payments are made over a period of several years to reduce the income tax which would otherwise result if the total payment were received in one sum.)

Life Insurance:

Insured: the employee.

Applicant and owner: the employer.

Beneficiary: the employer.

Split Dollar

Split dollar insurance is an attractive plan for any employee needing assistance in paying life insurance premiums and

for employers who wish to provide, at little or no cost, a fringe benefit to selected employees.

A split dollar life insurance plan provides an employer with the advantages of an employee benefit plan by being:

- Made available to those key employees individually selected by the employer, thus increasing the attractiveness of employment and reducing turnover.
- Tailored to the individual needs of each participant according to the employer's desires.
- Started, continued and discontinued with no government approval required.
- A tax-sheltered accumulating fund (the policy cash values) which is available for business needs and emergencies.
- One of very few fringe benefit plans under which a large part or all of the employer's costs are recovered.

The split dollar method of paying for life insurance is very attractive to selected (including stockholder-employee) participants because it:

- Provides a substantial amount of insurance at a lower cost than if paid for from personal after-tax income.
- Can become a self-completing plan in event of disability, through the addition of the waiver of premium provision.
- Allows the insured to acquire the entire life insurance policy in event of plan or employee termination prior to death.
- Can be arranged so the proceeds are not included in the insured's taxable estate at death. (Special provisions may be required if the insured is the majority stockholder of a corporation.)
- Can be expanded, at the employer's option, into a plan which provides deductible retirement benefits.

Split Dollar Plan

Because of the substantial amounts that may be involved, it is preferable to spell out the rights and obligations of the employer, employee and beneficiary in writing.

There are two basic systems of arranging split dollar life insurance policies:

- **Collateral Assignment Method.** The *insured* (or sometimes a third party spouse, child or trust) applies for, owns, pays the premiums, and names the beneficiary of the life insurance policy. Part (or often all) of the premiums is loaned to the insured (or other policy owner) by the employer.

  The policy owner (normally the insured employee) collaterally assigns the policy to the employer as security for the premium amounts advanced by the employer.

- **Endorsement Method.** The *employer* applies for, owns, and pays the premiums of the life insurance policy, and the employee (or sometimes a third party) pays to the employer an agreed upon portion of the premium, if any.

  The employer is the beneficiary of an agreed upon portion of the death proceeds (usually the total employer contributions or—if greater—the cash value) and the other party to the agreement (usually the insured employee, but sometimes a third party) has the right to designate a beneficiary for the balance.

  The employer and selected employee determine the form and amount of insurance, plus the split of premium payments and split of death benefit. The insurance is applied for and the employee provides evidence of his/her insurability. The split dollar agreement is signed by both parties. (If the collateral assignment method is used, the policy owner signs a collateral assignment and promissory notes to the employer for the amount of premium advances).

Income Tax Aspects of the Plan

In the case of employer-employee related split dollar plans, the employer's premium contributions are not a deductible expense, but the proceeds paid at death to the business are received free of income tax. The employee receives a current taxable economic benefit from the plan. This economic benefit is the annual value of the employee's death benefit, measured by the term cost of the protection, reduced by any employee premium payment. The death

proceeds paid to the employee's beneficiary are received income tax free.

Life Insurance:

Party:	Collateral Assignment	Endorsement
Insured:	the employee.	the employee.
Applicant and owner:	the employee (or third party).	the employer.
Premium payor:	the employee (or third party) with loans from the employer.	the employer with contributions from employee (or third party).
Beneficiary:	the employer of a predetermined portion; the employee's (or third party's) beneficiary for the balance.	

Selective Protection (Bonus) Plan

A Selective Protection Plan is an informal employee benefit arrangement between an employer and one or more selected employees. The employer pays part or all of the premiums for a life insurance policy written on the life of the employee. The insured employee has all ownership rights to the contract. No government approval is required. The employer decides who is to be included and what insurance benefits are to be provided. Each payment, as made by the employer to the plan, is fully tax deductible as a business expense.

Income Tax Aspects of the Plan

- Premiums paid by the employer are deducted, for income tax purposes, as a regular business expense.
- The employee's reportable income is increased by the amount of the employer's premium contribution, similar to cash bonus. Thus, the employee's cost is the income tax on the employer's premium payments, plus any additional premiums paid by the employee.
- Cash value increases of the policy are not subject to current income tax, even though they are owned by and available to the employee.
- Death benefits paid to an employee's beneficiary are received free of income tax.
- Policy proceeds withdrawn by the employee during life are received income tax free to the extent of total premiums paid (both the employer's and any employee premiums).

Life insurance:

Insured: the employee.

Applicant and owner: the employee.

Beneficiary: as selected by the employee.

Premium payer: employer alone or employer and employee. As with any transaction involving legal or tax considerations, no irrevocable steps should be taken without legal, tax and insurance counsel.

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